IN THE

Supreme Court of the United States

OCTOBER TERM, 1960

No.

V. F. BOND, ET AL., *Petitioners*

v.

UNITED STATES OF AMERICA, *Respondent*

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

Perpetual Building Association, Samuel Scrivener, Jr., Trustee and Junior F. Crowell, Trustee, pray that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Fourth Circuit.

OPINIONS BELOW

The memorandum opinion of the United States District Court for the Eastern District of Virginia, Alexandria Division (App., *infra*, p. 1a), is reported at 172 F. Supp. 759. The unreported memorandum opinion of the United States District Court for the Eastern

District of Virginia, Alexandria Division, is printed, App., *infra*, p. 6a. The unreported opinion of the United States Court of Appeals for the Fourth Circuit is printed, App., *infra*, p. 8a. The unreported dissenting opinion of the United States Court of Appeals for the Fourth Circuit is printed, App., infra, p. 27a.

JURISDICTION

The decree of the United States Court of Appeals for the Fourth Circuit was entered on May 31, 1960. The jurisdiction of this court is invoked under 28 U.S.C., Section 1254(1).

QUESTIONS PRESENTED

1. Whether the priority of a mortgagee over a subsequent federal tax lien extends to sums paid by the mortgagee pursuant to the mortgage for real estate taxes accruing after the federal tax lien arises.

2. Whether the priority of a mortgagee over a subsequent federal tax lien extends to sums paid by the mortgagee after the federal tax lien arises and pursuant to the mortgage for attorneys fees to establish the priority of the mortgagee over the federal tax lien for sums paid by the mortgagee for local real estate taxes.

STATUTES INVOLVED

Internal Revenue Code of 1954:

SEC. 6321. LIEN FOR TAXES.

> If any person liable to pay any tax neglects or refuses to pay the same after demand, the amount (including any interest, additional amount, addition to tax, or assessable penalty, together with any costs that may accrue in addition thereto) shall be a lien in favor of the United States upon all prop-

erty and rights to property, whether real or personal, belonging to such person.

(26 U.S.C. 1958 ed., Sec. 6321.)

SEC. 6322. PERIOD OF LIEN.

Unless another date is specifically fixed by law, the lien imposed by section 6321 shall arise at the time the assessment is made and shall continue until the liability for the amount so assessed is satisfied or becomes unenforceable by reason of lapse of time.

(26 U.S.C. 1958 ed., Sec. 6322.)

SEC. 6323. VALIDITY AGAINST MORTGAGEES, PLEDGEES, PURCHASERS, AND JUDGMENT CREDITORS.

(a) Invalidity of Lien Without Notice.—Except as otherwise provided in subsection (c), the lien imposed by section 6321 shall not be valid as against any mortgagee, pledgee, purchaser, or judgment creditor until notice thereof has been filed by the Secretary or his delegate—

(1) Under state or territorial laws.—In the office designated by the law of the State or Territory in which the property subject to the lien is situated, whenever the State or Territory has by law designated an office within the State or Territory for the filing of such notice; or

(2) With clerk of district court.—In the office of the clerk of the United States district court for the judicial district in which the property subject to the lien is situated, whenever the State or Territory has not by law designated an office within the State or Territory for the filing of such notice; or

(3) With clerk of district court for District of Columbia.—In the office of the clerk of the United States District Court for the District of

Columbia, if the property subject to the lien is situated in the District of Columbia.

(b) Form of Notice.—If the notice filed pursuant to subsection (a)(1) is in such form as would be valid if filed with the clerk of the United States district court pursuant to subsection (a)(2), such notice shall be valid notwithstanding any law of the State or Territory regarding the form or content of a notice of lien.

(c) Exception in Case of Securities.—

* * * * * *

(26 U.S.C. 1958 ed., Sec. 6323.)

Revised Statutes:

SEC. 3466. Whenever any person indebted to the United States is insolvent or whenever the estate of any deceased debtor, in the hands of the executors or administrators, is insufficient to pay all the debts due from the deceased, the debts due to the United States shall be the first satisfied; and the priority established shall extend as well to cases in which a debtor, not having sufficient property to pay all his debts makes a voluntary assignment thereof, or in which the estate and effects of an absconding, concealed, or absent debtor are attached by process of law, as to cases in which an act of bankruptcy is committed.

(31 U.S.C. 1958 ed., Sec. 191)

STATEMENT

This action was commenced by a complaint (R. 3-15) filed by the United States on October 29, 1957 in the United States District Court for the Eastern District of Virginia, Alexandria Division, for the foreclosure of federal tax liens upon the property and rights to property of taxpayers V. F. Bond and Audrey A.

Bond. The complaint was filed pursuant to Sections 7401, 7402(a) and 7403, Internal Revenue Code of 1954 and Section 1345 of Title 28, U.S.C. (R. 3). The complaint alleged that there were assessed against taxpayers on December 20, 1955, deficiencies for the years 1943 through 1947, totaling $318,832.84 and against taxpayer V. F. Bond, on the same date, deficiencies for the year 1942 in the amount of $18,306.16 (R. 7, 8). The complaint further alleged that on or about December 20, 1955 notice of each of the assessments was served on taxpayers and demand for payment made and that taxpayers have refused to pay the amount assessed; it was further alleged that on December 21, 1955 notice of each of the described assessments was filed in the Office of the Clerk of the Circuit Court of Arlington County, Virginia, and other appropriate places. It was alleged that on July 2, 1957 the aforesaid assessments were reduced to judgment at which time the United States District Court for the Eastern District of Virginia found that there was due to the United States as of July 31, 1957 the sum of $343,318.45, plus interest, for the years 1943 through 1947 and $14,164.73, plus interest, for the year 1942 (R. 8, 9).

The complaint listed various items of real and personal property owned by taxpayers and named as defendants the parties having an interest in such property, including petitioners Perpetual Building Association, hereinafter called "Perpetual", Samuel Scrivener, Jr., Trustee and Junior F. Crowell, Trustee (R. 3). The complaint prayed for the appointment of a receiver to enforce the liens of the United States against the properties of taxpayers, that the liens against the various properties be determined and that

the liens of the United States should be foreclosed by a sale of the properties involved and the proceeds distributed in accordance with the findings of the Court (R. 14). After hearing, the District Court, on November 27, 1957, found that the United States had valid tax liens in the principal sum of $357,484.18, plus interest, and that taxpayers were insolvent. A custodial receiver and special master were appointed (R. 17-22). On September 24, 1958 the District Court entered an order confirming the sale of the Arlington Hotel for $172,500.00 (R. 41-43).

1. The pertinent facts may be summarized as follows:

Petitioners Samuel Scrivener, Jr., Trustee and Junior F. Crowell, Trustee, are Trustees under a mortgage[1] given by taxpayers on certain real estate in Arlington, Virginia, referred to in the record as the Arlington Hotel. This mortgage, dated July 13, 1955 and recorded July 15, 1955, secures payment of $100,000.00 to the treasurer of Perpetual (R. 30). Monthly payments were made on this mortgage until October 4, 1956, after which no further payments were made to Perpetual (R. 16). The monthly payments under the mortgage included $331.00 for local real estate taxes. The entire monthly payment was credited by Perpetual on the principal balance and then the amount of the local real estate taxes was charged against said balance when paid on behalf of taxpayers by Perpetual (R. 46, 47). The following are among the covenants of the mortgage:

[1] The instrument in question was actually a deed of trust, but there is no dispute that it qualified as a "mortgage" within the meaning of 26 U.S.C.A. § 6323(a), *supra*.

IT IS HEREBY COVENANTED:

* * * * *

(2) that any and all taxes and assessments, general or special, now or hereafter assessed against said realty shall be paid when due.

* * * * *

(7) that the title to said realty and the record of said title shall be kept free of litigation, infirmity and lien,

* * * * *

(10) that any and all disbursements made by the Treasurer because of the failure of the grantor to make any payment or do any act required to be made or done, with interest thereon at six per cent (6%) per annum, shall be demandable at any time by the Treasurer and until paid to the Treasurer shall be deemed to be secured by this deed of trust, and

(11) that if there shall be any default in the performance of any of the foregoing covenants, the Treasurer shall have the right and power to do any one or more of the following:

(a) do any act or make any disbursement, in his name or the name of the grantor, which he may deem necessary or proper to protect the lien of this Deed of Trust.

On August 7, 1956, August 6, 1957 and August 11, 1958, Perpetual paid local real estate taxes on the Arlington Hotel. The taxes for the year 1956 and a portion of said taxes for 1957 were paid with funds paid to Perpetual by taxpayers for that purpose. Perpetual paid $4,759.16 toward the 1957 taxes and all of the 1958 taxes in the sum of $4,787.16 with its own funds, taxpayers having made no payments on the mortgage with which to pay these taxes (R. 45-52).

Perpetual contends that, having paid the 1957 and 1958 real estate taxes pursuant to authority of the covenants of the mortgage, *supra*, it has a lien for the sums so paid superior to the federal tax lien; further, and also as a consequence of the covenants of the mortgage cited, *supra*, Perpetual contends that it has a lien for attorneys fees incurred in this litigation (the sum of $1,000.00 was allowed by the District Court, App., *infra*, p. 7a) in protecting the lien of its mortgage and that this lien for attorneys fees is also superior to the federal tax lien (R. 16, 17, 26).

The report of the special master gave priority to Perpetual for attorneys fees and other charges called for under the terms of the mortgage (R. 26). The United States took exceptions to the special master's report in this regard (R. 32, 33). The District Court ordered the sale of the Arlington Hotel subject to the liens thereon as found by the special master and reserved decision on questions of priority of lien raised by the exceptions of the United States to the special master's report (R. 37-39). The question of whether the lien of Perpetual for local real estate taxes paid by Perpetual after the filing of the federal tax lien was superior to the federal tax lien arose after sale of the Arlington Hotel and is first reflected in the record in the order of the District Court of January 1, 1959 by reservation of decision thereon (R. 43).

2. In determining the priorities of the various liens asserted against the proceeds of sale of the Arlington Hotel, the United States District Court held:

1. That the priority accorded Perpetual over the federal tax lien by virtue of Section 6323(a), I.R.C., 1954, extends to sums paid by Perpetual for local real estate

taxes for 1957 and 1958, the obligation of the mortgagor-taxpayer to pay these sums being secured by the mortgage to the same extent as the obligation to pay the principal, App., *infra*, p. 1a.

2. That the priority accorded Perpetual over the federal tax lien by virtue of Section 6323(a), I.R.C., 1954, extends to sums paid by Perpetual for attorneys fees to establish the priority of Perpetual for sums paid by Perpetual for local real estate taxes, the obligation of the mortgagor-taxpayer to pay these sums being secured by the mortgage to the same extent as the obligation to pay the principal, App., *infra*, p. 6a.

The United States Court of Appeals for the Fourth Circuit reversed the decision of the District Court and held that the federal tax lien is entitled to priority over the mortgagee for 1957 and 1958 real estate taxes and for the attorneys fees because the claim of the mortgagee for these items was deemed to be inchoate at the time the federal tax lien arose, App., *infra*, p. 8a.

SUMMARY OF ARGUMENT

The choate lien test does not defeat the right of Perpetual to priority for sums paid for taxes and attorneys fees because this priority is compelled by the nature of a mortgage and also by the necessary implications of Section 6323(a), I.R.C., 1954, *supra*, pp. 3, 4. This Court has never applied the choate lien test, developed to defeat state-created liens competing with the federal tax lien where the taxpayer is insolvent, to the interest of a mortgagee. The question of the extent of the priority accorded to mortgagees by Section 6323(a) has never been passed upon by this Court.

In *United States* v. *New Britain*, 347 U.S. 81, the question of the right of the mortgagee to pay local real

estate taxes accruing subsequent to the federal tax lien and to have priority under Section 6323(a) over the federal tax lien for sums so paid was raised but not decided. That question is squarely raised in the case at bar.

Although the District Court below determined that the mortgagors-taxpayers here were insolvent, priority for the United States was not there asserted on the basis of Section 3466 of the Revised Statutes, *supra*, p. 4. See footnote to the opinion of the District Court, App., *infra*, pp. 1a, 2a. The Court of Appeals, App., *infra*, pp. 13a, 14a, held that the United States was foreclosed, as a consequence, from asserting priority under Section 3466 for the first time in the Court of Appeals.

The history of the choate lien test as developed to implement the purpose of Section 3466 of the Revised Statutes reveals that, while having never had occasion to pass on the question, this Court has stated several times that the priority of debts due the United States in insolvency would not affect an antecedent mortgage. A mortgage is more than a lien and constitutes the creation of an estate in the mortgagee and the divesting of an estate out of the mortgagor. A federal tax lien arising after a mortgage of property by the taxpayer can only attach to the property interest of the taxpayer in the mortgaged property, to-wit: the equity of redemption of the mortgagor-taxpayer. The extent of this equity of redemption is determined by the provisions of the mortgage.

Although Section 6323(a) is merely a recording statute, its effect is to accord priority to a mortgagee antecedent to the filing of the notice of the federal tax lien. The extent of the priority thus accorded the mortgagee

is measured by all the covenants of the mortgage and extends to sums paid under authority of the mortgage for taxes and attorneys fees after the filing of the federal tax lien. There being no exception of insolvency in the statute, the priority accorded the mortgagee by Section 6323(a) applies where the mortgagor-taxpayer is insolvent. Congress, in enacting Section 6323(a), intended that the priority provided should extend to expenditures to preserve the security of the mortgagee.

The mortgage of Perpetual being first in time is first in right. From its execution a mortgage is choate and perfected securing the performance by the mortgagor of all covenants therein. It is the priority of Perpetual over the United States which is in issue here, not the priority of the local taxing authority over the United States. The decision of this Court in *United States* v. *R. F. Ball Constr. Co.*, 355 U.S. 587, the only case before this Court in which a contractual lien (an assignment, not a mortgage)—as distinguished from a state-created lien—was competing with the federal tax lien, is not applicable here. The claim of Perpetual to priority is based on an instrument conceded to be a mortgage. Since the claim of Perpetual is based on a mortgage, priority should be accorded to Perpetual for its payments for taxes and attorneys fees under the reasoning of the minority in *United States* v. *R. F. Ball Constr. Co.*, *supra*.

ARGUMENT

The petition for a writ of certiorari should be granted because the question of federal law presented is of continuing importance, has never been passed upon by this court, and was decided wrongly below by the Court of Appeals. The question presented is

whether the priority of a mortgagee over a subsequent federal tax lien extends to sum paid by the mortgagee for local real estate taxes and attorneys fees accruing after the federal tax lien arose. The decision depends on whether the choate lien test developed by this court in preserving the priority accorded by Congress to debts due the United States where the debtor is insolvent is properly applicable to defeat the priority accorded a mortgagee by Section 6323(a), I.R.C., 1954, *supra*, p. 3.

The District Court held that Section 6323(a), *supra*, protects a mortgagee prior in time to a federal tax lien in paying local real estate taxes on the mortgaged property arising subsequent to the tax lien and further protects such a mortgagee to the extent of attorneys fees incurred in defending the priority of the mortgagee. The Court of Appeals reversed the District Court and gave the federal tax lien priority over the lien of the mortgage for local taxes and attorneys fees by applying the choate lien test to the claim of the mortgagee for these items. The Court of Appeals stated, in part, App., *infra*, p. 23a:

> * * * "Therefore, in view of the persistent application of the "choate lien test" by the Supreme Court, which doctrine was recognized and followed by the Ninth Circuit in United States v. Christensen, supra, we reach the conclusion in the instant case that the claimed priority for payment of the real estate taxes accruing after recordation of the federal tax liens, even though made pursuant to an authorized provision of a prior recorded mortgage, must be subordinated to the federal tax lien because such lien so acquired by the mortgagee was unperfected and inchoate at the time the federal tax liens were recorded."

This Court has never held that the choate lien test is applicable to a mortgage. In considering the applicability of the choate lien test to the lien of a mortgage, it appears apposite to consider briefly the genesis of this test and its judicial history to date.

I. HISTORY OF THE CHOATE LIEN TEST

A. The Choate Lien Test as Developed and Applied to Defeat State-Created Liens Where the Debtor of the United States Is Insolvent

Section 3466 of the Revised Statute, supra, p. 4 (hereinafter referred to as "The Insolvency Statute") provides, in substance, that where a debtor of the United States is insolvent, debts due the United States shall be first satisfied. While this statute provides for priority in favor of the United States, it is arguable that a lien should be preferred to a debt due the United States unaccompanied by a lien. This contention was rejected by this court in *Thelusson* v. *Smith*, 15 U.S. (2 Wheat.) 396, the first case construing The Insolvency Statute wherein a judgment creditor claimed priority based on the fact that his judgment constituted a lien. The Court held that to defeat the government's right to priority the judgment lien creditor must have enforced his lien by reducing the property to possession, thus divesting the property interest of the debtor. See *Thelusson* v. *Smith*, 396, 427:

> * * * "Exceptions there must necessarily be as to the funds out of which the United States are to be satisfied, but there can be none in relation to the debts due from a debtor of the United States to individuals. The United States are to be first satisfied; but then, it must be out of the debtor's estate. If, therefore, before the right of preference has accrued to the United States, the debtor has made

a bona fide conveyance of his estate to a third person, or has mortgaged the same to secure a debt, or if his property has been seized under a fi. fa., the property is divested out of the debtor, and cannot be made liable to the United States. A judgment gives to the judgment-creditor a lien on the debtor's lands, and a preference over all subsequent judgment creditors. But the Act of Congress defeats this preference, in favor of the United States, in the cases specified in the 65th Section of the Act of 1799."

It is to be noted that a mortgagee is exempted from the impact of The Insolvency Statute—not only because a mortgage constitutes a choate lien, but also because the estate of the debtor in the property is thereby divested.

In *Conard* v. *Atlantic Ins. Co.*, 26 U.S. (1 Pet.) 386, 441, the contention was that *Thelusson, supra*, had held that only an absolute conveyance was sufficient to defeat the federal priority and thus a mortgage, being merely a lien, should be subordinated to the priority of accorded debts due the United States. This contention was rejected thusly:

> * * * "It is true, that in the discussions in courts of equity, a mortgage is sometimes called a lien for debt and so it certainly is, and something more: it is a transfer of the property itself, as security for the debt. This must be admitted to be true at law: and it is equally true in equity: for in this respect, equity follows the law. It does not consider the estate of the mortgagee as defeated and reduced to a mere lien, but it treats it as a trust estate, and according to the intention of the parties, as a qualified estate, and security. When the debt is discharged, there is a resulting trust for the mortgagor. It is, therefore, only in a loose and general sense, that it is sometimes called a lien, and then only by way of contrast to an estate absolute and

> indefeasible. But it has never yet been decided by this court, that the priority of the United States will divest a specific lien, attached to a thing, whether it be accompanied by possession or not."

In *Brent* v. *Bank of Washington*, 10 Pet. 596, 611, 612, the priority of the mortgagee over the United States in insolvency was reiterated as follows:

> * * * "It has been the uniform construction of this act (the insolvency statute), . . . that whether in a case of insolvency, death or assignment, the property of the debtor passes to the assignee, executor or administrator; the priority of the United States operating, not to prevent the transmission of the property, but giving them a preference in payment out of the proceeds. *Conard* v. *Atl. Ins. Co.*, 1 Peters, 439.
>
> This preference is in the appropriation of the debtor's estate; so that if, before it has attached, the debtor has conveyed or mortgaged his property, or it has been transferred in the ordinary course of business, neither are over-reached by the statutes; 1 Peters, 440; and it has never been decided that it affects any lien, general or specific, existing when the event took place which gave the United States a claim of priority. (Insertion mine)"

In none of the cases cited above has this Court had before it a case where the federal priority was being asserted to defeat a mortgage. For subsequent cases noting in *dicta*, the priority of a mortgage in insolvency because the property mortgaged is, subsequent to the mortgage, no longer a part of the debtor's estate, see *Savings & Loan Society* v. *Multnomah County*, 169 U.S. 421, 428; *United States* v. *Texas*, 314 U.S. 480, 484 and *New York* v. *Maclay*, 288 U.S. 290, 292.

In *Maclay, supra,* the choate lien test got its name through the characterization of a competing state tax lien as inchoate. Certiorari was granted to decide the question of whether or not the federal priority commanded by The Insolvency Statute obtained where the competing claim was a lien as well as a debt. Citing *Thelusson, supra,* the court held that a lien must be so specific as to bring about a change of title or possession. Referring to the line of cases beginning with *Conard, supra,* with regards the position of mortgages in insolvency, the court refused to speculate as to what the rule might be in jurisdictions where a mortgage created only a lien and nothing more. In this regard, however, the court noted, 288 U.S. 290, 292, that "a mortgage, even though a lien is one much more specific than a judgment or a tax, much closer to ownership".

Although this court has not decided a case turning on the point, lower federal courts, following *Conard, supra,* have consistently upheld the priority of mortgages executed by the debtor prior to a determination of insolvency. See *United States* v. *Guaranty Trust Co.*, 33 F. 2d 533, Aff'd. on other grounds, 280 U.S. 478, *Exchange Bank & Trust Co.* v. *Tubbs Mfg. Co.*, 246 F. 2d 141 and *Bank of Wrangell* v. *Alaska Asiatic Lumber Mills*, 84 F. Supp. 1. In *Guaranty Trust, supra,* the competing federal claim was not a federal tax lien. In *Exchange Bank & Trust Co.* and in *Bank of Wrangell,* the competing federal claim was a federal tax lien. In the former case, the court relied on Section 6323(a), *supra,* in preferring the mortgage. In the latter case, no mention was made of 6323(a) and the case seems to have been decided on the basis that the property interest of the debtor had been diminished by

the giving of the mortgage. This was consistent with the line of cases beginning with *Conard, supra.*

Federal tax liens secure "debts due the United States" and following the rationale of *Thelusson*, this court proceeded to develop highly technical tests to be applied to liens competing with the federal tax lien in insolvency cases. The court required that the competing lien be: "specific in amount" (*New York* v. *Maclay, supra*); enforceable without the assistance of the courts (*United States* v. *Texas*, 314 U.S. 480, 488); attached to a specific property (*United States* v. *Waddill; Holland & Flinn*, 323 U.S. 353, 356, 357); and "specific" to the extent that the lien is attached by reducing the property to possession (*United States* v. *Gilbert Associates*, 345 U.S. 361, 366). In all of these cases, the court was concerned with competing statutory liens created by state law.

B. The Choate Lien Test as Applied to Defeat State-Created Liens Where the Debtor of the United States Is Solvent

In *United States* v. *Security Trust & Savings Bank*, 340 U.S. 47, this court, for the first time, applied the choate lien test developed in the insolvency cases to the lien of a creditor of a solvent federal tax debtor. Here again, the question of priority arose between the federal tax lien and a state-created lien—an attachment. This court held that when the federal tax lien arose, the attachment was inchoate because it was only a "caveat of a more perfect lien to come".

The validity of the analogy in *Security Trust* to the choate lien test developed in the insolvency cases is questionable. The essential difference between the "pure" lien priority cases and the insolvency cases is that a federal priority is provided by federal statute in

the insolvency cases! No federal priority has ever been legislatively provided in the lien cases. Consequently, the federal tax lien arises under Section 6322 when the federal tax is assessed and competing state-created liens should arise as provided by state law, provided that the federal courts would deal with each state-created lien on its merits and deal with the problem of the relation back of a state-created lien according to the type of lien it was considering in a particular case. If the choate lien test developed in the insolvency cases is to be carried over into the lien priority cases, then, except as Section 6323(a) may be applicable, it is doubtful if any lien, while it still remains a lien, can defeat the federal tax lien in a priority contest.

In *United States* v. *New Britain*, 347 U.S. 81, this Court held, in a conflict of liens between the City of New Britain for real estate taxes and water rents and the federal government's tax liens, that the rule of first in time is first in right should apply—despite the fact that local tax liens were not among the interests mentioned in Section 6323(a). The court accepted the specificity of the local tax liens under state law, even though they had not been enforced by taking possession of or title to the real estate in question.

In the next year, this Court, in three opinions by Mr. Justice Minton, the author of *New Britain*, again applied the choate lien test in non-insolvency cases to defeat three state-created liens. See *United States* v. *Acri*, 348 U.S. 211 (Ohio Attachment Lien); *United States* v. *Liverpool & London Ins. Co.*, 348 U.S. 215 (Texas Garnishment Lien); *United States* v. *Scovil*, 348 U.S. 218 (South Carolina Landlord's Lien). Subsequently, the Court, in four memorandum opinions, held mechanic lien claims subordinate to the federal tax

lien. See *United States* v. *Colotta*, 350 U.S. 808; *United States* v. *White Bear Brewing Co.*, 350 U.S. 1010; *United States* v. *Vorreiter*, 355 U.S. 15; United *States* v. *Hulley*, 358 U.S. 66.

On June 20, of this year, this Court handed down two opinions in which a subcontractor was preferred to the federal tax lien on the ground that the property right of the general contractor-taxpayer in the proceeds of the construction contract was reduced under state law by: (1) the right of the subcontractor to create a personal liability on the owner to pay the subcontractor rather than the taxpayer (*United States* v. *Durham Lumber Co.*, October Term 1959, No. 23); (2) the duty of the general contractor to hold the proceeds in trust for the payment of any unpaid subcontractors. (*Aquilino* v. *United States*, October Term 1959, No. 1). In *Aquilino*, the case was sent back to the Court of Appeals of New York with direction that that court determine the validity of the contention that the genera contractor was obligated under New York law to hold the contract proceeds as trust funds. In both of these cases, the Court relied on its previous decisions in *Morgan* v. *Commissioner*, 390 U.S. 78 and *United States* v. *Bess*, 357 U.S. 51 holding that state law determines the property or rights to property to which a federal tax lien attaches.

In *Aquilino* and *Durham Lumber* (hereinafter sometimes referred to as "Durham Lumber"), the taxpayer was the general contractor. In previous mechanic lien cases, the taxpayer had been the owner. Previous lien priority cases involving mechanic's liens in this Court, all *per curiam*, preferred the federal tax lien apparently because the mechanic's lien was inchoate to the

extent that it had not been reduced to final judgment at the time the federal tax lien attached. In *United States* v. *White Bear Brewing Co.*, *supra*, this was the holding despite the fact that a suit to enforce the lien had been filed and the liened property sold in that proceeding prior to the inception of the federal tax lien.

In *Durham Lumber*, this Court holds that because the claim contesting with the federal tax lien on the property of the taxpayer does not, under state law, constitute in form a lien on the property of the taxpayer, such claim is not subject to the choate lien test. It should be noted that in *Durham Lumber* the federal tax lien attached to the property interest of the taxpayer (the chose in action against the owner) prior to action by the subcontractors to perfect any rights they might have under state law to reduce the property interest of the general contractor-taxpayer. It is assumed that under state law the subcontractor was required to file a lien (*Aquilino*) or give notice to the owner (*Durham Lumber*) in order to limit the property interest of the general contractor in the chose in action. Even though the right of the subcontractor is not a lien upon the property of the taxpayer, the effect of the perfection thereof by the subcontractor is to diminish the property interest of the taxpayer subsequent to the effective date of the federal tax lien as against the subcontractor.

The analogy of *Durham Lumber* to the case at bar seems clear. Perpetual under its mortgage (accorded priority over federal tax liens by Section 6323(a), I.R.C., 1954) had a right to be secured for the payment of local real estate taxes paid by it upon default by the mortgagor in his obligation under the mortgage to pay these taxes. The subcontractors in *Durham Lumber*

had a right under state law (previously held by this Court ineffective to defeat the federal tax lien by the imposition of a lien) to reduce the property interest of the taxpayer by perfecting their claims in the event the general contractor-taxpayer failed to pay them as he was obliged to do. Assuming, for purposes of argument, that the lien of Perpetual arose upon payment of the real estate taxes subsequent to the effective date of the federal tax lien against Perpetual, under the holding of *Durham Lumber*, Perpetual should be preferred for these payments. Whereas state law in *Durham Lumber* made the interest of the taxpayer subject to being diminished by action of the subcontractors after the effective date of the tax lien against them, the mortgage had the same effect on the taxpayer in the case at bar.

If the rule be that in *Durham Lumber* the general contractor-taxpayer under state law *never* had a property interest superior to the claim of the subcontractors, the answer in the case at bar is that the mortgagor-taxpayer under the mortgage never had a property interest superior to the claim of Perpetual for reimbursement. This is particularly true when the nature of a mortgage as creating an estate in the mortgagee is invoked.

C. The Choate Lien Test as Applied to Defeat Contractual Liens Other Than Mortgages

In *United States* v. *R. F. Ball Constr. Co.*, 355 U.S. 587, this Court decided *per curiam* the only case to come before it to date where the lien competing with the federal tax lien was a contractual lien as opposed to a state-created lien. There, an assignment by a subcontractor of the proceeds of a construction contract

to his performance bond surety as security for any liability the surety might sustain under its bond for the performance of the contract or on subsequent similar bonds was held to be inchoate and inferior to a federal tax lien arising after the surety has obligated itself on a subsequent bond on the basis of the assignment.

In large measure, it is to resolve in its favor the conflicting opinions as to the implications of the *per curiam* opinion of the majority in *Ball* that Perpetual seeks a writ of certiorari. The Court of Appeals in the case at bar was of the opinion that the majority of this Court in *Ball*, accepting the holding of the lower court that the assignment was in legal effect a mortgage, held that a mortgage is subject to the choate lien test. The dissenting judge in the Court of Appeals was, on the other hand, of the opinion that this Court in *Ball* held that the assignment, not being a mortgage in the ordinary sense, was not protected under 6323(a), I.R.C., 1954, from the impact of a subsequent federal tax lien and was therefore held to be inchoate. Perpetual contends that *Ball* did not constitute a holding that the choate lien test is applicable to a mortgage, but rather a refusal of this Court to extend the meaning of "mortgage" under Section 6323(a) to an instrument not a mortgage in form or substance. See *United States* v. *Gilbert Associates*, *supra*, wherein this Court rejected the contention of a municipality that its tax liens gave it the status of a judgment creditor under 6323(a). This Court in *Ball* was not called upon to decide, as it is in the case at bar, whether the choate lien test applies to a mortgage in view of Section 6323(a). *Ball* merely held that the assignment was not a mortgage and, as a consequence, was inchoate and inferior to the federal tax lien. Certainly, a full opinion

would have resulted if *Ball* had constituted a judicial limitation on the protection afforded mortgagees by Section 6323(a).

D. The Choate Lien Test as Applied to Defeat the Priority Accorded to Mortgagees Under Section 6323(a), I.R.C., 1954

In *United States* v. *Christensen*, 269 F. 2d 624, relied on by the United States below, the United States Court of Appeals for the Ninth Circuit, citing *United States* v. *New Britain*, *supra*, preferred a federal tax lien to the claim of a mortgagee for local real estate taxes paid by the mortgagee after the federal tax lien arose. The Court, ignoring the argument of the mortgagee that the payment of the local taxes were secured by the mortgage *ab initio*, construed Section 6323(a), I.R.C., 1954, to provide that a federal tax lien is invalid against the interest of a prior mortgagee as reflected in the outstanding balance for principal and interest secured by the mortgage at the time notice of the federal tax lien is filed. It is significant that the court also summarily dismissed the citation to *United States* v. *Bess*, *supra*, with no attempt in its opinion to either apply or distinguish that case.

The mortgagee has almost universally been preferred with respect to attorneys fees and similar expenses incurred subsequent to the filing of a federal tax lien. See *Ormsbee* v. *United States*, S.D. Fla., 23 F. 2d 926; *United States* v. *Sampsell*, 9 Cir., 153 F. 2d 731; *United States* v. *Halton Tractor Co.*, 9 Cir., 258 F. 2d 612; *Smith* v. *United States*, D.C. Hawaii, 113 F. Supp. 702; *Bank of America Nat. Trust & Savings Ass'n.* v. *United States*, D.C.S.D., Cal., 84 F. Supp. 387, but see *in re New Haven Clock & Watch Co.*, 2 Cir., 253 F. 2d 577. The mortgagee has likewise been preferred as to

the real estate taxes paid subsequent to the filing of the federal tax lien. See *United States* v. *Miller*, D.C.S.D., Fla., 55-1 U.S.T.C., Par. 9484; cf. *United States* v. *Lord*, D.C.N.H., 155 F. Supp 105. In *Rikoon* v. *Two Boro Dress, Inc.*, 171 N.Y.S. 2d 19, the local taxes were preferred as an expense of sale under the New York Statute. In *Peoples Bank* v. *United States, D.C.N.D.*, Ga., 98 F. Supp. 874, the mortgagee was given priority over the federal tax lien for subsequent advances on an open-end mortgage. The case was reversed on appeal on the ground that the subsequent advance was a separate transaction unsecured by the lien of the first mortgage. See *United States* v. *Peoples Bank*, 5 Cir., 197 F. 2d 898. The United States Circuit Court of Appeals for the Second Circuit in *Pipola* v. *Chicco*, 2 Cir., 274 F. 2d 909 preferred a mortgagee whose mortgage had arisen after the federal tax lien, where the settling attorneys had failed to note the recorded tax lien, on the theory that the second mortgagee, having paid off the prior mortgage which had priority over the federal government, was entitled to the same priority as the first mortgagee. All of these cases disclose the overwhelming sentiment of the majority of the lower federal courts toward construing the federal tax lien strictly in cases involving a mortgagee.

II. THE CHOATE LIEN TEST IS NOT APPLICABLE TO A MORTGAGE

The choate lien test is not applicable to a mortgage because of the nature of the mortgage and also because of Section 6323(a), I.R.C., 1954. As we have seen, this Court has noted consistently, albeit in *dicta*, that a mortgage is more than a lien. See *Conard* v. *Atlantic Ins. Co.*, and *United States* v. *Maclay*, both *supra*. In Virginia, a mortgage is a conveyance and in equity

vests legal title in the trustee to the extent of the obligation secured. See *Larchmont Homes, Inc.* v. *Annandale Water Co.*, 201 Va. 178, 110 S.E. 2d 249.

Among the obligations secured by the instant mortgage was the duty of the mortgagee to pay the local real estate taxes on the mortgaged property. While at law the claim of a mortgage may be regarded as a lien, in equity it is regarded as an estate. More accurately, the mortgagee's interest is said to be an estate terminable upon a condition, to-wit: the performance of the covenants of the mortgage. The equitable estate of the mortgagee is not diminished by the federal tax lien which attaches only to the equity of redemption of the taxpayer. The mortgagor's equity of redemption is determined by the contract of the parties. Until such time as all covenants of the mortgage are fully performed, the property interest of the taxpayer in the mortgaged property is determined by the mortgage. It matters not whether a mortgage be classified as a lien *or* a conveyance. Throughout this Country a mortgage creates at the least an equitable estate in the mortgagee. For this reason, if for no other, subsequent federal tax liens do not attach to the estate of the taxpayer previously conveyed by a mortgage. See *United States* v. *Durham Lumber Co.*, and *Aquilino* v. *United States*, both *supra*.

Now let us examine the impact of Section 6323(a), I.R.C., 1954, *supra*, on the question presented. Section 6322, I.R.C., 1954, *supra*, provides that, unless another date is fixed by law, the federal tax lien arises when the tax assessment is made. Thus, this statute, originally Act of July 13, 1866, ch. 184, 14 Stat. 107, created a secret lien which could affect the rights of subsequent

creditors without their knowledge. In *United States v. Snyder*, 149 U.S. 210, the Supreme Court ruled that the federal tax lien, although unrecorded as required by state law, was valid against a purchaser without notice of it. As a result of this decision, Congress in 1913, Act of March 4, 1913, ch. 166, 37 Stat. 1016, amended the tax lien statute so that it protected mortgagees, purchasers and judgment creditors by requiring recordation of the federal tax lien in the local jurisdiction in order that it might be valid against such interests. This amendment is presently designated Section 6323(a), *supra*. It is to be noted that Section 6323(a), on its face, limits the effective date of the federal tax lien without an exception for cases arising under the insolvency statute.

Section 6323(a) is nothing more than a recording statute giving notice to certain classes of creditors who would otherwise be prejudiced by the secret lien for federal taxes created by Sections 6321 and 6322. The effect of Section 6323(a) is, however, of necessity, to give priority to mortgagees prior in time to the filing of the notice of the tax lien. If, under Section 6323(a), a mortgagee becoming such after the federal tax lien arises under Section 6322, is not affected by the tax lien, a mortgagee established as such prior to the inception of the tax lien under Section 6322 *a fortiori* is entitled to at least the same priority. Indeed, since the federal tax lien statute gives no priority to the federal tax lien, all liens arising before the federal tax is assessed should have priority as provided by state law, unless the taxpayer is insolvent, in which case a limitation on state-created liens is compelled to implement the insolvency statute. Section 6323(a), being a limitation on Section 6322, this Court is clearly justified in strictly construe-

ing the interests thereby excluded from the effect of the tax assessment. However, where the competing interests are created prior to the tax assessment, there appears to be no congressional imperative to limit the rule of "first in time is first in right" except in insolvency and, even there, the imperative has been qualified by judicial construction as we have seen. Unless priority for its tax liens is an attribute of the sovereignty of the United States, the propriety of the application of the choate lien test in the absence of insolvency to competing liens arising *prior to the assessment of the federal tax* would appear doubtful. In the instant case, the mortgage of Perpetual was executed July 13, 1955 and recorded July 15, 1955; the federal taxes were assessed on December 20, 1955.

The congressional intention that federal tax liens should be treated as other liens is evident from the Report of the United States House of Representatives when Section 6323 was adopted. In H. R. Rep. No. 1018, 62d Cong., 2d Sess. 1-2 (1912) the following is stated:

> * * * "A person proposing to buy the property of another could protect himself against such a lien only by ascertaining from all the collectors in the United States whether or not the vendor was delinquent in the payment of taxes. This would be a great hardship and would make it practically impossible for any person proposing to buy property to secure himself against such liens. The same hardship would devolve upon mortgagees and judgment creditors. . . . (The amendment) provides a very simple means of giving this notice that would not at all be burdensome upon the Government. . . . The recent act relating to excise tax by corporations makes it imperative that some legislation of this kind be enacted in order to pro-

tect the transfer of property, and to facilitate business transactions. *There is no reason why the government should not occupy the same position with reference to liens on property as does the individual.*" (Italics mine)

While Congress in enacting Section 6323(a), was not concerned to protect local statutory liens as against the federal tax lien, Congress, by the same token, certainly did not intend to restrict the right of an antecedent mortgagee to protect itself contractually against state taxes. Nor did Congress intend that this contractual protection, as integral to the mortgage as all other obligations secured thereunder, should be vitiated by a federal tax lien subsequent to the mortgage. The contest here is not between a state-created lien and the federal lien; rather, it is between the mortgagee and the federal tax lien. The priority of the federal tax lien over the state tax lien is irrelevant to the issue presented.

Even if the choate lien test be applied, the mortgagee should prevail. It is obvious that the identity of the lienor and the property subject to the lien are established upon execution of the mortgage. If there is any uncertainty, it is as to the amount of the lien. All that is required in this regard is that the obligation secured by the mortgage be sufficiently identified. See the dissenting opinion in *United States* v. *R. F. Ball Constr. Co., supra.* It is submitted that the requirement of the certainty of amount arose out of and is solely applicable to the garnishment, attachment, mechanic's lien and landlord's lien cases where the amount of the lien would be subject to subsequent litigation wherein the amount claimed by the lien would be liquidated; in which cases, it was

obvious that the amount for which the lien was filed might not be the amount ultimately determined to be due. Further, in these cases, there was something more that the creditor had to do and, presumably, could have done to perfect his claim prior to the effective date of the federal tax lien against him. Obviously, Perpetual in the instant case was powerless to prevent the accrual of local real estate taxes or to remove the lien of these taxes from the security if the mortgagor-taxpayer failed to pay them as he covenanted to do in the mortgage. Accordingly, the lien of the local real estate taxes was anticipated by the provisions of the mortgage whereby the covenant to pay said taxes was secured by the mortgage. The Court of Appeals in its opinion rejected the citation to *United States* v. *Seaboard & Citizens Nat. Bank*, 4 Cir., 206 F. 2d 62, for the proposition that the mortgage from its inception secured the payment of the local taxes and the attorneys fees. In that case, an automobile subject to a chattel trust was seized by the government for violation of the Internal Revenue laws. The automobile was ordered sold by the District Court and a controversy arose over whether the remittance, based on the mortgagee's interest, should include a 15% attorneys fee as secured by a covenant of the mortgage. Judge Parker, writing for a unanimous court, 206 F. 2d 62, 63, upheld the continuing validity of a covenant in an antecedent mortgage over intervening federal claims as follows:

> * * * "It is argued that the attorneys fees were incurred after the seizure of the automobile and that, since the foreclosure became absolute at that time, remission under the statute should not cover attorneys fees subsequently earned. The answer is that, prior to the seizure, the mortgage secured

the debt to the bank and expenses which might be incurred in collecting it, including attorneys fees, and that in remitting the interest of the mortgagee from the forfeiture incurred by the mortgagor, there is no reason to exclude any part of the obligation secured by the mortgage."

The Court of Appeals, App., *infra*, pp. 24a-26a, distinguished *Seaboard & Citizens* on the ground that the federal statute involved was not the federal tax lien statute. The *Seaboard* case represents a determination by a federal court that under Virginia law the entire debt is secured by the mortgage from its inception including any provision for attorneys fees. It is submitted that, the mortgage in this case having arisen prior to the assessment of the federal tax against the mortgagor, there is no reason to restrict state law construing the interest created by the mortgage. This court held in *United States* v. *Security Trust & Sav. Bank*, *supra*, that the state's classification of a lien is entitled to weight, but subject to re-examination by this court.[3]

The situation of Perpetual here should be contrasted with the situation in *United States* v. *R. F. Ball Constr. Co.*, *supra*. In that case, the surety, in the face of the recorded federal tax lien, assumed for another consideration further liability on behalf of the taxpayer in a situation where there was no obligation to assume such further obligation. The obligation assumed bore no relation to the original assignment except as it purported to be secured by it. The surety, in assuming the further liability in the face of the federal tax lien, was not acting to protect the initial security since the original contract had been performed and, presumably, the taxpayer had fulfilled its obligations

thereunder. Certainly in such a case the surety is in a much weaker position than Perpetual here.

In Arlington County, Virginia, the situs of the mortgaged property, real estate taxes: (1) constitute a lien on property prior to any other lien or encumbrance;[2] (2) are a lien on the fee simple estate in real estate;[3]

[2] § 58-1023, Code of Virginia, 1950. LIEN ON REAL ESTATE FOR TAXES AND LEVIES.—There shall be a lien upon all real estate for the taxes assessed and county, district, city and town levies assessed thereon, prior to any other lien or encumbrance thereon. The words "taxes" and "levies", as used in this section, include the penalties and interest accruing on such taxes and levies in pursuance of law.

[3] § 58-1024, Code of Virginia, 1950. TAXES IN CERTAIN CITIES AND COUNTIES A LIEN ON FEE SIMPLE ESTATE, NOT MERELY ON INTEREST OF OWNER.—In any city totally surrounded by a county which has adopted and in which there is in effect the county executive form of county organization and government as provided by §§ 15-272 to 15-304, and in any county of the Commonwealth which has adopted and in which there is in effect the county executive form of county organization and government as provided by §§ 15-272 to 15-304:

(1) Taxes assessed against real estate subject to taxes shall be a lien on the property and the name of the person listed as owner shall be for convenience in the collection of the taxes. The lien for taxes shall not be limited to the interest of the person assessed but shall be on the entire fee simple estate. There shall be no lien when for any year the same property is assessed to more than one person and all taxes assessed against the property in one of the names have been paid for that year.

(2) When taxes are assessed against land in the name of a life tenant or other person owning less than the fee or owning no interest, the land may be sold under §§ 58-1014 to 58-1020 or any other laws for the sale of land for delinquent taxes provided the owner of record or his heirs be made parties to the proceeding for sale.

(3) Proceedings for the sale of land under such sections may be instituted any time after the five per centum penalty is added.

and (3) subject land to sale for delinquent taxes.[4] The tax lien is superior to all prior encumbrances. See *Simmons* v. *Lyles*, 32 Gratt. (73 Va.) 752; *Thomas* v. *Jones*, 94 Va. 756, 27 S.E. 183; *Stevenson* v. *Henkle*, 100 Va. 591, 42 S.E. 672. Perpetual's payment of the real estate taxes involved prevented the imposition of a prior lien on the mortgaged property. No case has been found in Virginia ruling upon the priority of payments pursuant to a mortgage over the rights of subsequent lienors. A mortgage (as in the case at bar, the instrument was a deed of trust) for future advances was approved in principle in *Alexandria Sav. Institution* v. *Thomas*, 29 Gratt. (70 Va.) 483, wherein the competing claimant obtained a judgment after all advances had been made under a mortgage given solely to secure future advances. This case supports the proposition that, where a mortgage is bound by contract to make future advances, priority over subsequent encumbrances is afforded to such advances. See 29 Gratt. 483, 489 as follows:

> * * * "The cases are generally agreed that when the mortgagee is bound by his contract with the mortgagor to make advances or incur liabilities in the future, he will take precedence over any subsequent encumbrance given by the mortgagor although he may have had actual notice of such encumbrance at the time the advance was made or the liability incurred."

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[4] § 58-1029, Code of Virginia, 1950. WHEN TREASURERS TO SELL DELINQUENT LAND.—On the second Monday in December in the year next after the year in which the treasurers submit their lists of delinquent real estate to the boards of supervisors of their counties and the councils of their cities, as required by § 58-983, each such treasurer shall sell, as hereinafter provided, all the real estate embraced in his list of delinquent real estate, on which the levies for which the same was returned delinquent, or any part thereof, may remain unpaid on the day of sale.

The imperative for the payment for local taxes and attorneys fees in the case at bar is not contractual albeit such payments were authorized by the contract. The obligation to incur the expenditures in question to protect the security is nonetheless compelling within the rule recognized above.

It should be noted in this regard that the 1957 taxes were paid by Perpetual prior to the institution of the instant litigation, at which time Perpetual was not charged with notice of the federal tax lien. The 1958 taxes, on the other hand, and the attorneys fees were incurred after the institution by the United States of this proceeding to enforce its liens. The state of the law with regard to the right of the mortgagee to remove a junior federal tax lien by foreclosure in the ordinary manner or by exercise of the power of sale in the deed of trust of Perpetual prior to the decisions of this Court handed down June 13 of this year in *United States* v. *Brosnan*, and *Bank of America* v. *United States*, October Term 1959, Nos. 137 and 183, respectively, placed Perpetual in a position where it could not, by its own action, remove the federal tax lien except by proceeding under 28 U.S.C., Section 2410, in which proceeding the title would have been unmarketable because of the one year right of redemption in the federal government. As a consequence, Perpetual could not avoid holding the property for at least one year and felt advised to await proceedings by the United States to foreclose its lien, in which proceeding Perpetual would not be compelled to purchase the property. Certainly Perpetual's position should not be prejudiced with respect to the priority of its mortgage because of the accrual of the subsequent tax liabilities while the lien of the United States was being enforced. Even the most

succinct and cogent rationale supporting such a decision could not allay the patent injustice of such a result.

III. EXPENDITURES BY A MORTGAGEE PRIOR IN TIME TO THE FEDERAL TAX LIEN FOR ATTORNEYS FEES TO PRESERVE THE PRIORITY OF THE MORTGAGEE ARE ENTITLED PRIORITY OVER THE FEDERAL TAX LIEN

The rationale for priority for the attorneys fees incurred by Perpetual over the federal tax lien is the same as the rationale for priority for the sums paid for local real estate taxes. The estate of the mortgagor-taxpayer was reduced upon the execution of the mortgage by the conveyance of the mortgaged property as security for the payment of any attorneys fees expended to preserve the priority of the security. Likewise, under Section 6323(a), I.R.C., 1954, *supra* the mortgagee is preferred to the federal tax lien to the extent of the covenant securing expenses incurred in protecting the priority of the mortgagee.

CONCLUSION

The writ of certiorari should be granted and the judgment of the United States Court of Appeals for the Fourth Circuit reversed.

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